



(Billing Code 5001-06-P)

**DEPARTMENT OF DEFENSE**

**Defense Acquisition Regulations System**

**48 CFR Part 231**

**RIN 0750-AH76**

**Defense Federal Acquisition Regulation Supplement: Unallowable Fringe Benefit Costs (DFARS Case 2012-D038)**

**AGENCY:** Defense Acquisition Regulations System, Department of Defense (DoD).

**ACTION:** Final rule.

**SUMMARY:** DoD is issuing a final rule amending the Defense Federal Acquisition Regulation Supplement (DFARS) to explicitly state that fringe benefit costs that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable.

**DATES:** Effective [Insert date of publication in the FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:** Ms. Susan Williams, telephone 571-372-6092.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

DoD published a proposed rule in the Federal Register at 78 FR 13606 on February 28, 2013, to revise the DFARS at 231.205-6 to implement the Director of Defense Pricing policy memo

"Unallowable Costs for Ineligible Dependent Health Care Benefits", dated February 17, 2012. This rule adds paragraph 231.205-6(m)(1) to explicitly state that fringe benefit costs that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable.

## **II. Discussion and Analysis of Public Comments**

DoD reviewed the public comments in the development of the final rule. A discussion of the comments and the changes made as a result of those comments is provided, as follows:

### **A. Summary of significant changes from the proposed rule.**

After consideration of a public comment, DoD determined that the reference to "incurred or estimated" within the DFARS text should be deleted.

**B. Analysis of public comments:** Two respondents submitted comments on the proposed rule.

#### **1. Policy Memo disagreement**

Comment: One respondent disagreed with the conclusions of the Director of Defense Pricing policy memorandum. However, the respondent agreed that contractors should monitor healthcare dependent eligibility to ensure only proper healthcare charges are included as an element of fringe benefit costs.

Response: The memorandum emphasizes and clarifies existing policies but does not create new policies. These existing policies make fringe benefit costs unallowable when such costs

are unreasonable or conflict with law, employer-employee agreement, or an established policy of the contractor. DoD shares the respondent's belief that contractors should have adequate internal controls to ensure improper healthcare charges are excluded from fringe benefit costs. The rule encourages contractors to adopt reasonable internal controls to eliminate costs that are already unallowable.

## **2. Broadening the category of fringe benefits**

Comment: One respondent took exception to the rule addressing the broad category of fringe benefits when the Director of Defense Pricing policy memorandum only addresses the cost of health care benefits for ineligible dependents.

Response: The policy at FAR 31.205-6(m) states, in part, that fringe benefit costs are allowable to the extent they are required by law, employer-employee agreement, or an established policy of the contractor. The DFARS policy memo addressed only the area that has experienced recent problems. Reasonable internal controls can significantly reduce the amount of ineligible dependent healthcare claims that are already unallowable if they fail to meet the conditions in FAR 31.205-6(m). The same logic applies to all fringe benefits.

## **3. Immaterial and no-impact**

Comment: One respondent asserted that industry-wide ineligible dependent costs are immaterial, and thus have no

impact on contract billing or pricing. The respondent suggested that DoD should review the DCAA findings in its policy memo 09-PSP-016(R), dated August 4, 2009, before proceeding with further rulemaking.

Response: Research indicates the rate of ineligible dependent claims can represent as much as 3 percent or more of total healthcare costs. The overall cost for ineligible dependent claims, which are often fraudulent, can be significant for large contractors that spend millions of dollars for dependent healthcare. Programs to reduce ineligible dependent healthcare claims have been shown to benefit both the contractor and its customers. Penalties may be assessed if unallowable dependent healthcare costs are contained in a final indirect cost rate proposal, or a final statement of costs incurred, or estimated to be incurred, under a fixed-price incentive contract.

#### **4. Cost Accounting Standard**

Comment: One respondent asserted that the treatment of ineligible fringe benefit costs as expressly unallowable does not comport with Cost Accounting Standard (CAS) 405 and its preambles. In the preamble of the original publication of CAS 405, the CAS Board explained its use of the term "expressly" in the definition of "expressly unallowable cost" as "...that which is in direct and unmistakable terms." The respondent believed that "fringe benefit costs...contrary to law, employer-employee

agreement, or an established policy of the contractor" are not direct and unmistakable costs.

Response: The rule makes fringe benefit costs expressly unallowable when such costs are contrary to law, employer-employee agreement, or an established policy of the contractor. The Director of Defense Pricing Policy determined these conditions are direct and unmistakable.

## **5. Overlapping protection**

Comment: One respondent asserted that the rule is unnecessary since the FAR cost principles already protect the Government. Contractors are currently required to exclude fringe benefit costs that do not meet the requirements for reasonableness per FAR 31.201-3.

Response: The results of the DCAA audits have made it clear that coverage is not sufficiently clear. The intent of the rule is to make fringe benefit costs expressly unallowable when such costs conflict with law, employer-employee agreement, or an established policy of the contractor. Unallowable fringe benefit costs, such as ineligible dependent healthcare claims, unnecessarily increase the cost of Government contracts. Because contractors are already required to exclude unallowable costs from final indirect cost rate proposals or a final statement or cost incurred, penalties will only accrue to contractors that fail to comply with rules that already exist.

## **6. Relationship to the application of penalties**

Comment: One respondent was concerned that the proposed rule does not conform to the FAR as it relates to the application of penalties. The respondent indicated that FAR 42.709-1 is limited to applying penalties only to unallowable costs included in an indirect cost proposal. The respondent further stated that there is no language in FAR 42.709-1 about "estimated" costs and because of this the respondent asserted that the reference to estimated costs in the proposed rule must be deleted.

Response: While subsection FAR 42.709-1 does not expressly use the term "estimated", this subsection does state that the penalties discussed in the subsection "apply to contracts covered by this section." FAR 42.709, entitled "Scope," specifically covers the assessment of penalties for including unallowable indirect costs in indirect cost rate proposals, or the "final statement of costs incurred or estimated to be incurred ..." (emphasis added). Nevertheless, DoD has deleted the phrase "incurred or estimated" from DFARS 231.205-6(m)(1).

## **7. Test of reasonableness**

Comment: One respondent suggested that the costs should be judged by the test of reasonableness and not treated as unallowable with the associated penalties. The proposed rule would make these costs unallowable, thus forcing companies to

expend disproportionate sums to ensure no claims for costs include ineligible health care costs in order to avoid the penalties. According to the respondent, this would force companies to behave differently than companies in the commercial marketplace or the U.S. Government in managing these costs.

Response: Ineligible fringe benefit costs are already unallowable under existing regulations. Thus, the test for reasonableness does not apply because an unallowable cost cannot, by definition be reasonable. Per FAR 31.205-6(m), fringe benefit costs are only allowable to the extent they are reasonable and are required by law, employer-employee agreement, or an established policy of the contractor. The DFARS rule only makes expressly unallowable fringe benefit costs that contractors are already required to exclude from forward pricing rates, incurred cost proposals, and billings. Research indicates nearly 70 percent of commercial companies have implemented procedures to detect and eliminate ineligible dependent health care claims in order to reduce costs and remain competitive. Therefore, the effect of the rule is to make the DFARS consistent with current commercial practice.

## **8. Internal controls**

Comment: One respondent asserted that, if a company's internal controls are found to be unreasonable, the Government can cite the contractor for a business system deficiency and

disallow cost. Dependent healthcare costs are allowable until eligibility ceases, so the Government should focus on the reasonableness of the company's internal controls (i.e., reasonableness test) versus the allowability test. A company should not be required to pay penalties if it has adequate internal controls to prevent charging the Government for ineligible dependent healthcare costs or recover and credit those costs back to the Government when they are charged.

Response: The rule makes ineligible dependent healthcare costs expressly unallowable, and subject to penalties, when such costs are contained in a final indirect cost rate proposal or a final statement of costs incurred, or estimated to be incurred, under a fixed-price incentive contract. Penalties may be waived in accordance with FAR 42.709-5(c).

#### **9. Exceeding the actual costs of ineligible benefits**

Comment: One respondent asserted that the costs of internal controls should not exceed the actual costs of the ineligible benefits. Treating the costs for ineligible dependent healthcare costs as unallowable is likely to force companies to spend more money than they would otherwise, in order to avoid the penalties associated with unallowable costs. The result will be increased allowable costs to the Government in exchange for little or no value.



Response: Research indicates the cost of ineligible dependent health care claims often far exceeds the cost of dependent verification programs. DoD was unable to find any studies or other evidence indicating that the cost to detect ineligible claims is higher than the cost savings.

**10. Possible disfavor for those who are fully or partially subject to CAS**

Comment: One respondent asserted that the proposed rule has the effect of discriminating against companies that are fully or partially subject to CAS. The respondent asserted that, for those fully subject to CAS and those partially subject to CAS, the potential risk for liability for claiming unallowable costs is significant, while companies that are not subject to CAS have no such liability and do not face the possibility of False Claims Act prosecutions, Civil False Claims Act damages, qui tam lawsuits or debarment/suspension. A rule that allows companies subject to CAS to use a reasonable method for dealing with these costs will reduce the cost to the companies and reasonably protect the government from paying for the costs of ineligible dependent healthcare costs.

Response: The rule and, thus, the potential liability to incur penalties, apply equally to all contractors regardless of whether they are subject to CAS. Therefore, the rule does not discriminate against companies that are fully or partially

subject to CAS. Additionally, the assertion that companies not subject to CAS do not face the possibility of False Claims Act prosecutions, Civil False Claims Act damages, qui tam lawsuits or debarment/suspension is inaccurate.

### **III. Executive Orders 12866 and 13563**

Executive Orders (E.O.s) 12866 and 13563 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). E.O. 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This is not a significant regulatory action and, therefore, was not subject to review under section 6(b) of E.O. 12866, Regulatory Planning and Review, dated September 30, 1993. This rule is not a major rule under 5 U.S.C. 804.

### **IV. Regulatory Flexibility Act**

A final regulatory flexibility analysis has been prepared consistent with the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*, and is summarized as follows: This final rule amends the Defense Federal Acquisition Regulation Supplement (DFARS) at 231.205-6 to explicitly state that fringe benefit costs incurred

or estimated that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable. After consideration of a public comment, DoD determined that the reference to "incurred or estimated" within the DFARS proposed rule text should be deleted.

The objective of this final rule is to explicitly state that fringe benefit costs incurred or estimated that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable. Although fringe benefit costs that do not meet these criteria are not allowable, the Federal Acquisition Regulation (FAR) does not make them expressly unallowable. Specifying these fringe benefit costs are expressly unallowable in the DFARS makes the penalties at FAR 42.709-1 applicable if a contractor includes such unallowable fringe benefit costs in a final indirect cost rate proposal or in the final statement of costs incurred under a fixed-price incentive contract.

No comments were filed by the Chief Counsel for Advocacy of the Small Business Administration in response to the proposed rule.

DoD does not expect this final rule to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because this rule merely provides clarification of

existing policies by expressly stating that fringe benefit costs incurred or estimated that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable.

The final rule imposes no reporting, recordkeeping, or other information collection requirements.

There are no known significant alternatives to the rule. The impact of this rule on small business is not expected to be significant.

#### **V. Paperwork Reduction Act**

The rule does not contain any information collection requirements that require the approval of the Office of Management and Budget under the Paperwork Reduction Act (44 U.S.C. chapter 35).

#### **List of Subjects in 48 CFR Part 231**

Government procurement.

**Manuel Quinones,**

Editor, Defense Acquisition Regulations System.

Therefore, 48 CFR part 231 is amended as follows:

#### **PART 231-CONTRACT COST PRINCIPLES AND PROCEDURES**

1. The authority citation for 48 CFR part 231 continues to read as follows:

**Authority:** 41 U.S.C. 1303 and CFR chapter 1.

2. Section 231.205-6 is amended by adding paragraph (m)(1) to read as follows:

**231.205-6 Compensation for personal services.**

\* \* \* \* \*

(m)(1) Fringe benefit costs that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable.

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